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IN THE

Supreme Court of the United States

October Term, A. D. 1936

No. 743

A. A. LEWIS AND COMPANY, MAIN AND LINCOLN AVENUE SUBDIVISION, TRUST NO. 1523, CENTRAL REPUBLIC BANK AND TRUST COMPANY, as Successor Trustee by consolidation,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONERS.

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I.

OPINIONS AND JUDGMENT BELOW.

The judgment order of the Circuit Court of Appeals reversing the decision of the United States Board of Tax Appeals appears on page 53 of the Record. No opinion was handed down. The Board of Tax Appeals rendered a memorandum opinion (R. 36-38) which is not officially reported.

II.

JURISDICTION.

This case is before this court on a writ of certiorari granted March 29, 1937 to review a decision of the United States Circuit Court of Appeals for the Seventh Circuit, which reversed the decision of the United States Board of Tax Appeals, disallowing deficiency income tax assessment for the year 1931.

III.

STATEMENT OF CASE.

On December 12, 1925, Minerva S. Melidones, hereinafter called "Grantor," entered into two agreements respecting certain real estate owned by her in the Village of Niles Center, Cook County, Illinois. One of the agreements designated "Declaration of Trust" (R. 13-17) provided for the placing of the title to said real estate in the Chicago Trust Company of Chicago (predecessor of Central Republic Trust Company) as Trustee for the "ultimate use and benefit of" the Grantor and A. A. Lewis as their interests should appear from the agreement attached to said declarations of trust. The trust so created was known as Trust No. 1523 and the Declaration of Trust in question was upon the printed form bearing the imprint of said Trust Company.

The said declaration of trust provided that while the Trustee had full power to deal with the real estate so far as the public was concerned, it was agreed by the parties that it would do so only in accordance with the provisions of the said agreement attached thereto. It also provided

(R. 15) that the beneficiary should have the management and control of the trust property and of the selling, renting and handling thereof. The said agreement (R. 17-34) so attached to the trust agreement and containing provisions relative to the sale of the property was of even date therewith, and was executed by the Grantor, the sales agent A. A. Lewis, and the said Trustee. Lewis was an experienced real estate man who specialized in the subdivision of land in the vicinity of Niles Center, Illinois. Under the agreement (R. 22) Lewis was appointed by the Grantor exclusive selling agent of the land which was to be subdivided, the Grantor, however, reserving the right (R. 30) to withdraw any unsold property from the operation of the sales agreement after nine months from the date thereof. The Grantor appointed Lewis "Manager of the Trust" (R. 22). The Grantor delegated to Lewis "such power and duties in connection with the administration of the Trust as may be necessary to facilitate the sale of the land." He was also given exclusive possession of the property during the continuance of the sales arrangement (R. 41) and was given power to direct the Trustee to issue conveyances of any lots sold and paid for.

Among the powers specifically delegated to Lewis were the following: (R. 23-24) To exercise management and control of the trust property for the purpose of selling it, to employ at his own expense a sales organization, select and approve purchasers for the lots, both as to character and financial responsibility and to request the Trustee to execute deeds and other instruments. Lewis agreed at his own expense to advertise the property for sale (R. 27) and as sole compensation for his services was to receive a specified cash commission, based upon the price of the lots sold (R. 29).

The initial payment on each contract up to the amount of Lewis' commission was to be retained by him to apply on

his commission. All subsequent payments were to be collected by the Trustee who was to retain for its compensation 3½% of collections made by it. All costs of surveying, expense of putting real estate in shape for sale, expense of laying down cement sidewalks, and Trustee's fees were to be borne by the Grantor (R. 30). All expenses of sale, including compensation of salesmen were to be paid by said Lewis out of his agreed commission (R. 31).

The duties of the Trustee, as specified in the Declaration of Trust (R. 13) and attached agreement (R. 32) were as follows: To hold title to the real estate; to issue certificates of beneficial interest; to deal with said real estate on written direction of the Grantor and under certain circumstances, of the said Lewis; to execute contracts to purchasers when directed to do so by said Lewis; to consent to assignments of contracts at the direction of said Lewis; to collect payments on contracts subsequent to the down-payment, and to disburse all moneys received under the provisions of the agreement; to keep books of account and to retain its compensation from the amounts so collected. The Central Republic Trust Company afterwards became successor in trust through the consolidation of the Chicago Trust Company with it.

The said Minerva S. Melidones was the owner of the property at the time of the formation of the trust. Her interest was assigned to Benjamin Swartz and his estate is the sole beneficiary. No other persons than the above were at any time beneficiaries under the trust (R. 9).

IV.

STATUTES INVOLVED.

The Revenue Act of 1928, c. 852, 45 Stat. 791, provides in part as follows:

Sec. 701. Definitions.

(*a*) When used in this Act—.

• • • • •

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies. (U. S. C. Title 26, Sec. 1696).

V.

SPECIFICATION OF ERRORS.

The only error to be argued is that the Circuit Court of Appeals erred in reversing the decision of the Board of Tax Appeals.

VI.

THE QUESTION PRESENTED.

Whether the trust in question is an "Association" within the meaning of Section 701 (*a*) (2) of the Revenue Act of 1928 and hence taxable as a corporation.

VII.

SUMMARY OF ARGUMENT.

The argument will be presented under the following subdivisions:

1. The Trust was not engaged in a business enterprise for profit.
   (*a*) The trustee was given no discretionary powers.
   (*b*) The sales agent was appointed by the Grantor and was at all times under her control.
2. The Trust is not *quasi* corporate in form.
   (*a*) The beneficiary of the Trust was not immune from liability.
   (*b*) There was no Trustee or Committee having powers of doing business analogous to a Board of Directors of a corporation.
   (*c*) The Trust was not of the business or Massachusetts type.
3. The Trust has but a single beneficiary.
4. Conclusion.

VIII.

ARGUMENT.

We assume at the outset that if it were not for the trust feature involved in the instant case, no contention would be made by the Commissioner of Internal Revenue that a taxable "association" existed. Lacking the trust feature, there would have been a simple subdivision and sale of lots by a single owner through an agent. Therefore, the question involved would seem to be narrowed down to an answer to the query: "Did the addition of the trust feature result in the formation of an 'association' in the meaning of the Revenue Act?"

When this case was argued before the Circuit Court of Appeals for the Seventh District, it was apparent that both the Petitioners and Respondents relied largely upon the decision of this court in the case of *Morrissey* v. *Commissioner*, 296 U. S. 344, as being decisive of the issue involved. The Petitioner there (Respondent here) contended that the facts in this case brought it squarely within the definition of "association" as laid down in the *Morrissey* case, while the Respondents there (Petitioners here) contended that the facts of the instant case left it clearly outside the definition of an "association" as there laid down.

It seems to us that a situation is here presented different from that presented in any of the cases previously decided by this court. It is apparent, from a study of those cases, that the trusts involved were of the Massachusetts type, or at least of a type very similar thereto. Inasmuch as this type of trust was developed for the express purpose of obtaining the advantages inherent in the corporate form of organization without incurring the burdens incidental thereto, it probably appeared reasonable to Congress to subject trusts of that type to the same requirements as corpora-

tions so far as payment of revenue to the Federal government was concerned, putting into effect the old adage, "Let the tail follow the hide."

Here, however, is a trust which is lacking in many of the features characteristic of and necessary to a Massachusetts trust, and the question arises whether it was the intention of Congress that a trust of this type be considered an "association."

Prior to the decision of the *Morrissey* case, this court in its opinion in the case of *Hecht* v. *Malley*, 265 U. S. 144, had enunciated the principle that a trust, to be considered an "association," must have two fundamental characteristics: First, it must be engaged in carrying on a business enterprise; Second, it must have a *quasi* corporate organization,

This brings us to the consideration of the first point stated in our summary:

THE TRUST WAS NOT ENGAGED IN A BUSINESS ENTERPRISE FOR PROFIT.

It is apparent that Minerva S. Melidones was engaged in the business of subdividing and selling her real estate through an agent of her own appointment. Does it necessarily follow, however, that the trust was "engaged in carrying on a business enterprise," as prescribed in the case of *Hecht* v. *Malley*, (*supra*) or "maintained as a medium for the carrying on of a business enterprise and sharing its gains," as stated in the *Morrissey* case, (*supra*)?

In one sense, any person or agency participating in any way in a business enterprise can be said to be "engaged" in it. In this very narrow sense it might be said that a salesman employed by the sales agent was "engaged in"

the business of selling the real estate in question. It seems apparent, however, that the language used in the two leading cases above referred to and set out in the excerpts quoted was not intended in that narrow signification. It was intended, it seems to us, to signify ultimate responsibility for management and direction of a business enterprise. In the familiar type of a business or Massachusetts trust, the power to manage and direct the business (or to mismanage it to its ruin in some cases) is explicitly vested in the trustees of the organization.

But the trustee in the trust here presented had no such power. Its powers were entirely ministerial and involved the exercise of no discretion whatever. They were the powers which are ordinarily conferred upon trustees in naked land title holding trusts with the addition that the trustee here was authorized to make collections upon contracts and to distribute same according to specific provisions of the sales contract.

The powers contained in the Declaration of Trust (R. 13) were entirely controled by the following provisions (R. 15):

> "• • • it is understood and agreed by the parties hereto and by any person who may hereafter become a party hereto, that said Chicago Trust Company will deal with it only when authorized to do so in writing, and then it will on the written direction of (in accordance with the attached agreement) or on the written direction of said person or persons as may be beneficiary • • • at the time • • •." (Parentheses are ours, but indicate wording which was written in typewriting in the printed form of the Declaration of Trust.)

And also (R. 15):

> "The beneficiary or beneficiaries hereunder shall have the management and control of said property and of the selling, renting and handling thereof. • • • "

The powers of the trustee contained in the sales agreement are shown principally in Sections 2 to 7 inclusive in Article VIII of the agreement, (R. 32 and 33) and relate to the collection of deferred payments upon contracts, the distribution of same and the keeping of books and records.

It will be observed that the trustee had nothing to do with the sale of lots, the procuring of purchasers, or passing upon their eligibility. The provision for a commission of only 3½% of collections to the trustee would in itself serve to confirm the contention that the trustee was not expected to exercise any but ministerial duties.

It is true that very broad powers were exercised by A. A. Lewis, the sales agent, but it will be apparent from inspection of the contract that the sales agent was appointed by the beneficiary and not by the trustee. In the inducement to the contract (R. 19), the following language appears:

> "And, Whereas, the said party of the first part (Melidones) is desirous of securing the services of the party of the second part (Lewis) in selling the lots in said subdivision. • • • " (Parentheses ours.)

And again in Article I (R. 20):

> "The party of the first part does hereby constitute the party of the second part • • • exclusive sales agent of said property."

In further confirmation of our contention that the beneficiary and not the trust was engaged in a business enterprise, we desire to cite the case of *Beilin* v. *Krenn & Dato*, 350 Ill. 284. In that case the owner of the property, corresponding to Minerva S. Melidones in the instant case, was itself a business trust. The title to the real estate was placed in a land title trust almost exactly corresponding in its terms to the trust here in question. The Court held that the beneficiary was the one actually engaged in the sale of the subdivided property and liable upon all con-

tracts entered into by the sales agent, who was denominated "Manager" as in the instant case.

What then was the function of the trustee in the business enterprise in question here? Principally that of an escrowee. By the device of placing title in a trustee, the sales agent was protected from the refusal by, or inability of, the principal to carry out the terms of the sales agreement; the purchasers of lots upon deferred payments were assured that the title would be protected from the viscissitudes to which it might be subject in the hands of the owner, and available for transfer to them upon completion by them of the payments due on their contracts; the holders of encumbrances upon the property were assured that the money received from the sale of lots would be applied in reduction of their encumbrances. All of these functions of the trustee were of a fiduciary nature and we submit could not be considered as the carrying on of a real estate sales business.

It is apparent that the powers and duties of the trustee in this trust were totally different from the powers and duties of the trustees in the trusts which have been previously passed upon by this court in the cases adjudicated by it.

THE TRUST IS NOT QUASI CORPORATE IN FORM.

There can be no question but that the trust form of organization has certain inherent resemblances to the corporate form. We conceive, however, that a valid distinction may be drawn between resemblances which are inherent in the bare nature of the trust form and those which arise out of the fact that the trust has been shaped and adapted to resemble the corporate form as closely as possible. The business or Massachusetts trust is of course illustrative of the type last referred to. This type is designed primarily for the purpose of the carrying on of business enterprises

and possesses all of the salient features enumerated on page 359 of the opinion in the *Morrissey* case (*supra*).

In most of such trusts the powers of the trustees are much greater than those possessed by the directors of corporations. Corporate directors are practically always elected by stockholders at regular intervals, and hold their position securely only in the intervals between stockholders' meetings. On the other hand, in nearly all of the trusts of the business type, the trustees are a self-perpetuating board and are not subject to control by the beneficiaries of the trust. They exercise not only the powers of directors but of officers as well in many instances.

As a general proposition, beneficiaries in business trusts are not personally liable beyond the assets embarked in the undertaking, although in some of the states this immunity has been refused. In trusts of this type, the trustees deal at arm's length with the parties on the other side of the transaction. They owe no duties to opposing parties, except such duties as the law imposes on all persons in a similar transaction. If they could be said to act in a fiduciary relationship, such relationship could apply only to their own beneficiaries.

The trust here considered has the resemblances to the corporate form which are inherent in its nature as a trust, but none which arise from an attempt to make it serve the purposes and obtain the immunities of the corporate form of organization. Inasmuch as there is a single beneficiary, the use of a trust could afford no benefit in the way of centralization of power. No trustees were named who were charged with the conduct of the enterprise—who were to act "in much the same manner as directors." No attempt was made to limit the liability of the beneficiary to the property embarked in the undertaking. In other words, this trust is not of the highly technical and conventional type carefully and painstakingly worked out by skilled lawyers

seeking for a loop-hole by which statutory regulations and taxes might be avoided, but arises out of an effort to safeguard the parties interested from different angles in the same transaction by the introduction of a disinterested outsider qualified by law and experience to serve in a fiduciary capacity for the benefit of all interested parties.

We do not understand that the quality of being "quasi corporate" is wholly dependent upon the possession of any one characteristic, although the use of the words "distinguishing them from partnerships" appearing on page 360 of the opinion in the *Morrissey* case, (*supra*), would seem to indicate that the liability of the beneficiaries beyond the property embarked in the undertaking is of considerable importance.

In the final determination of the question whether a given trust is a *quasi* corporation, it would seem that not only its form but its purpose is important. Here the purpose was entirely that of furnishing protection to the different parties rather than of obtaining immunities by aping a corporate structure.

THE TRUST HAS BUT A SINGLE BENEFICIARY.

In considering the meaning of the word "association," in his opinion in the *Morrissey* case, Chief Justice Hughes on page 356 says:

> "'Association' implies associates. It implies the entering into of a joint enterprise • • • ."

The New Century Dictionary defines the word "associate" as "A companion; comrade or mate; a partner or ally; a colleague."

It would seem to us apparent that associates must have some common interest in the enterprise, either as trustees exercising broad powers to carry on a business, or as joint

beneficiaries of a trust. We have not been able to find a adjudicated case where an association was declared t exist in which was lacking plurality of trustees or in th number of beneficiaries.

Respondents made the following claim in the petition fo appeal filed by him in the Circuit Court of Appeals (R. 41) "The above described trust is an organization composed o 'beneficiaries' and 'agent' and 'a trustee' • • •."

The contention that an agent is also an associate doe not seem tenable. If the agent be eliminated as an associat it would leave only the sole beneficiary and the truste It is apparent from the reading of the agreement that th trustee had no joint interest in the transaction with the so beneficiary. Its duty was in the nature of agency rath than participation in a joint enterprise. It could not, und any circumstances, share in any joint profits derived fro the enterprise.

CONCLUSION

We submit that there is a very vital distinction betwe the type of trusts in question in all of the previous cas decided by this court and the trust in question here, an respectfully ask that the decision of the Circuit Court Appeals of the Seventh District, reversing the decision the Board of Tax Appeals be reversed by this court.

Respectfully submitted,

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